

Submission

Of

**HKEx in Response to
the Consultation Document on Proposals
To Enhance the Regulation of Listing
In Hong Kong**

**14 January 2004
(Updated on 3 February 2004)**



Hong Kong Exchanges and Clearing Limited

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**SUBMISSION OF HKEX IN RESPONSE TO CONSULTATION DOCUMENT ON
PROPOSALS TO ENHANCE THE REGULATION OF LISTING IN HONG KONG**

EXECUTIVE SUMMARY

1. **HKEx Advocates Reform** - HKEx has consistently advocated significant reforms to Hong Kong's present framework for listing regulation. HKEx does not consider that the defects in the present system lie in the content of the Listing Rules or the institutional arrangements. The key defect is the absence of statutory obligations for listed companies and their controllers and directors (in particular financial reporting and disclosure requirements), and of statutory sanctions for infringements of such requirements. HKEx welcomes the focus of the Consultation Document on these issues. A further area in which Hong Kong's securities market framework warrants improvement is the statutory protections available to minority shareholders against abuse by controlling shareholders or company managements, in particular the extent and usability of legal remedies available to investors (paras 1-3).

2. **Statutory Disclosure Obligations** - The central issue raised in the Consultation Document is the extent to which additional statutory "teeth" are necessary to ensure compliance with certain key investor protection provisions which are presently contained only in the SEHK Listing Rules. These provisions are currently backed up only by the non-statutory investigative and sanctioning powers of HKEx. The key provisions, whose inclusion in primary legislation has been and continues to be advocated by HKEx (c.f. the submissions made by HKEx to the Expert Group, available at website www.hkex.com.hk), include the regular financial reporting obligations of listed companies, disclosure obligations in relation to corporate transactions (particularly connected transactions) and the obligation to disclose price-sensitive information (paras 5-23).

3. **Systemic Safeguards** - Extensive safeguards against potential conflicts of interest within HKEx are already built into Hong Kong law and the existing institutional arrangements. There has been no evidence that these safeguards are not working.

HKEx has no incentive to list companies that are likely to be a source of corporate irregularities or to damage HKEx's reputation. HKEx has a twelve-year track record of devoting appropriate resources to listing regulation since the "three-tier system" was established in 1991. Numerous provisions are already built into the system to ensure that the listing function is adequately resourced (paras 24-30).

4. **Three-Tier System** - The involvement of both the SEHK and SFC in regulation of listed companies ("shared regulation") can and should produce net regulatory benefits, as happens in other jurisdictions. The present three-tier structure contains in-built checks and balances which prevent an excessive and unhealthy concentration of administrative power and are an important mechanism for ensuring regulatory oversight and accountability. If the "watchdog" becomes the maker and administrator of the Listing Rules, there is no longer a watchdog (paras 31-35).
5. **Model A** - Model A in the Consultation Document (Transfer of Listing Functions to a new Division set up under the SFC) would effectively destroy the checks and balances within the three-tier structure. Such concentration of functions within the SFC would create new conflicts of interest, as well as arousing market concern that such a powerful body might take regulation to excess, or that its decisions (being difficult to challenge) might become high-handed or arbitrary. Implementing Model A would additionally be very costly in terms of administrative and legislative time and resources (paras 37-43).
6. **Constitutional Issues** – Model A raises serious constitutional issues. If the Listing Rules are made by the SFC, they would necessarily become subsidiary legislation. This would make them cumbersome to amend and administer. Turning them into a code of conduct or guidelines, instead of rules, would be impractical. It has been suggested that the Rules might be re-formulated so that only general principles are contained in statute, which would then be interpreted by means of codes or guidelines issued by the SFC.
7. **Model B** - Model B (Transfer of Listing Functions to New HKEx Subsidiary) resembles a proposal made by HKEx to the Expert Group. This was designed

(among other things) to ensure clarity concerning the reporting lines and accountability of the Listing Division and to provide a yet further safeguard against perceived conflicts of interest. This model is compatible with Model D (paras 44-47).

8. **Model C** - HKEx does not see merit in Model C (Transfer of Listing Functions to a New Statutory Authority Independent of both SFC and HKEx) (para 48).
9. **Model D** - HKEx considers Model D (Expanding the Dual Filing System) the most appropriate basic model. This would build on existing institutions, rather than seeking to impose radical change. The present division of functions between the SFC and HKEx would be retained, except that the SFC would be more actively involved in setting disclosure standards and would be the ultimate enforcement agency for any new statutory obligations. This model corresponds to the regulatory structure in the majority of other international markets (paras 49-58).
10. **Modified Model D** - HKEx suggests certain modifications to Model D designed to reinforce accountability. The role of the Listing Committee should be clarified as being to make decisions on individual listing applications and potential de-listings. The Listing Division would make first instance decisions on all other matters (for example: listing approval for further issues of shares; interpretations of the Listing Rules and granting of waivers post-IPO) under the power delegated by the Listing Committee. The Listing Committee would be expanded and the balance between issuer and investor representatives would be improved. There would be a separate Listing Policy and Appeals Committee (“LPAC”), composed of experienced market participants, which would make decisions on listing policy matters (including the content of Listing Rules to be made by the SEHK) and hear appeals against decisions of the Listing Committee on individual listings and against decisions of the Listing Division on non-disciplinary matters. There would be a separate Disciplinary Appeals Committee. In addition, an independent committee of the Board of HKEx would be established whose role would be to review performance of the listing function, as well as its annual budget and quarterly reports from the LPAC and Listing Committee. This

independent committee would report its findings and make recommendations to the full Board, with a view to ensuring that the latter is able to fulfil its responsibilities. Additionally, a specific provision would be added to the MOU between the SFC and HKEx to the effect that the SFC will carry out an annual assessment of the quantity and quality of the resources of the Listing Division. HKEx will also review its system for responding to bona fide complaints by market participants about the handling of particular listing cases (para 55).

11. **Prospectus Vetting** - The vetting of IPO and other prospectuses for compliance with the Companies Ordinance should continue to be performed by the SEHK. Under the “dual filing” system (which came into effect in April 2003 with the Securities and Futures Ordinance (“SFO”)), the SFC also reviews the contents of prospectuses from a disclosure point of view. This avoids the necessity for companies to file prospectuses with two separate regulators. The new “dual filing” system appears to be working well (paras 59-61).
12. **Minority Shareholder Protection** – HKEx recommends that the statutory rights to fair treatment of minority shareholders and the legal remedies available to investors should be improved. The litigation process should also be made more investor-friendly (para 66).
13. **Conclusion** – Model D is HKEx’s preferred basic model. The modifications to this model suggested in para 54 would clarify accountability and improve operational efficiency. Either Model A or Model C would be disruptive to the market and fraught with problems which have not yet been addressed. Model A would destroy the checks and balances built into the present three-tier system and result in a potentially unhealthy concentration of administrative power. Conflicts of interest within HKEx are not the “problem” they have been made out to be. There is no need to alter the regulatory structure in order to resolve the perceived problems in “shared regulation”. Enactment of the statutory obligations proposed by HKEx would alleviate such perceived problems. In order to sharpen the “teeth” of the regulatory regime for deterring and dealing with corporate misconduct, Hong Kong’s statutory framework should be updated through primary legislation as suggested above. The existing institutional arrangements,

which have generally served Hong Kong well for over twelve years, should be maintained, while being improved via the modifications to Model D proposed in this submission.

CONSULTATION DOCUMENT ON PROPOSALS
TO ENHANCE THE REGULATION OF LISTING IN HONG KONG

SUBMISSION OF HKEx

I. INTRODUCTION

1. **HKEx is a Strong Advocate of Reform** - As Government is aware, HKEx has, in its submissions to the Expert Group and elsewhere, consistently advocated significant reforms to Hong Kong's framework for the regulation of listed companies. The report of the Expert Group did not (in the view of HKEx) address the main real defects in the present listing regime, which lie in our legislation rather than the contents or method of administration of the Listing Rules. HKEx therefore welcomes the focus in the Consultation Document on the basic issue, namely the statutory framework.
2. **Disclosure Obligations** - In particular, HKEx welcomes the fact that its proposal for enactment in the Securities & Futures Ordinance ("SFO") of statutory financial reporting and other disclosure obligations for listed companies (including disclosure of connected transactions), accompanied by statutory sanctions for breaches of such obligations, receives recognition in the Consultation Document. This is the most important element in the proposals which HKEx submitted to the Expert Group (available on HKEx's website). It addresses in the most effective way possible the perceived lack of "teeth" in the Listing Rules. It would bring Hong Kong's legislative framework for listed company regulation into line with that which prevails in the majority of other international markets. It would achieve this while preserving the present "three-tier" structure and building on existing institutions. HKEx agrees with the Consultation Document that the three-tier system and existing institutions have served Hong Kong well.
3. **Enhancing Minority Shareholder Rights** – HKEx believes that one of the most important areas in which Hong Kong's listing regime needs to be improved is in relation to statutory rights to fair treatment for minority shareholders and statutory protection against abuse by controlling shareholders

or company managements. Compliance with disclosure and fair treatment requirements can best be accomplished through a combination of enforcement by the regulators and private enforcement through civil rights of action. Disclosure obligations and shareholder voting in relation to connected transactions are mentioned later in this submission. The subject of legal remedies for investors is not covered in the Consultation Document. While these do not bear directly on the respective roles of the SFC and HKEx, HKEx believes that further consideration needs to be given to enhancing existing remedies and making it easier for shareholders to use them. Some relevant proposals have been put forward by the Standing Committee on Company Law Reform (“SCCLR”), which HKEx has supported. These go only part of the way, however, towards creating a practical means for investors who consider they have been the victims of abuse to seek redress through the Courts. While HKEx accepts that this subject is too wide and complex to have been made part of the current consultation exercise, we nevertheless hope that Government will pursue legislative amendments on this front also, to bring Hong Kong’s statutory investor protection fully into line with that of other leading international markets.

4. **“Statutory Backing”** - The term “statutory backing for the Listing Rules” is used frequently in the Consultation Document. What is understood by this phrase varies considerably among different parties, according to their points of view. In other jurisdictions, this term generally refers to statutory backing for the listing rules of the relevant exchange. In the present context, what is clearly intended is the enactment of statutory provisions which parallel some of those found in the present HKEx Listing Rules. It is in this sense that HKEx interprets the term. In other words, the Listing Rules would remain contractual (as opposed to statutory) obligations, while certain core disclosure obligations, which are currently found only in the Listing Rules, would be enacted as statutory obligations in the Securities and Futures Ordinance (“SFO”).

II. HONG KONG'S PRESENT LISTING REGIME

5. **Current Regulatory Framework** - The bulk of the requirements applying to listed companies in Hong Kong are found in the non-statutory Listing Rules and non-statutory Code on Takeovers and Mergers. There are some limited statutory requirements in the SFO including disclosure of interests and (of particular relevance) the “dual filing” arrangement introduced on 1 April 2003. The prospectus requirements in the Companies Ordinance apply to all companies, while the bulk of the Companies Ordinance only applies to the less than 20% of listed companies that are incorporated in Hong Kong. The current regulatory framework uniquely relies heavily on the Exchange’s Listing Rules, due to the lack of statutory ongoing disclosure requirements for listed companies and other issuers. These statutory disclosure requirements are a standard feature of the regulatory regimes in other major international markets.

6. **Principal Listing Requirements** - The principal listing requirements are set out in para 2.29 of the Consultation Document. Annex A of this paper describes in more specific terms the matters covered in the Listing Rules of the Stock Exchange of Hong Kong (“SEHK”).

7. **The Three-Tier System** - Under Hong Kong’s “three-tier” regulatory structure, the SEHK is the front-line regulator of listed companies and the body which makes the Listing Rules. The SFC occupies the second “tier”, exercising a supervisory or “watchdog” role over the Exchange in the performance of its responsibility for administering the Listing Rules. Both HKEx and the SEHK have a statutory duty under the SFO to maintain an orderly, informed and fair market. The SFC must approve all SEHK Listing Rules before they can take effect; the SFC provides policy input in response to requests from the HKEx Executive; the SFC closely monitors HKEx’s work, receives monthly reports and holds monthly review meetings, conducts periodic audits of the listing function and recommends changes of practice where it sees the need for these. As a “public body” under the Prevention of Bribery Ordinance, HKEx (including its listing function) is also audited periodically by the ICAC. The SFC is responsible for investigating and

prosecuting breaches of statutory requirements by listed companies and their directors.

8. **SFC Oversight of SEHK** - The manner in which the Listing Division and Listing Committee are expected to perform their functions is set out in a Memorandum of Understanding (“MOU”) between the SFC and SEHK (the original 1991 MOU was updated and extended in 2000, and again in 2003). This requires that the SFC be informed in advance or consulted on issues involving policy and a number of other matters. The SFC has power to direct the SEHK to make changes to its rules and procedures, to suspend or de-list companies and to intervene in other ways where it considers this to be necessary in the public interest. There are thus extensive checks and balances built into the three-tier system to ensure that the body which administers the Listing Rules discharges its regulatory obligations fairly, consistently and reasonably.
9. **Delegation of Prospectus-Vetting** - The SEHK also performs the important role of vetting prospectuses of listing applicants and listed companies to ensure compliance with the requirements of the Companies Ordinance. This task was assigned to the SEHK by means of the Securities and Futures (Transfer of Functions – Stock Exchange Company) Order of 10 December 2002 which was confirmed in early 2003.
10. **Dual Filing** - In April 2003, The Securities and Futures Ordinance (“SFO”) introduced the so-called “dual filing” regime which is described in the Consultation Document. This dual filing system represents a form of “statutory backing” for many of the disclosure obligations in the Listing Rules. The dual filing system was a major advance in Hong Kong’s regulatory regime, but it stops short of bringing Hong Kong’s statutory disclosure regime fully into line with best international standards.

III. PERCEIVED DEFICIENCIES OF THE PRESENT REGULATORY REGIME

11. **Enforcement of Listing Rules** - The central issue raised in the Consultation Document is the extent to which additional statutory “teeth” are necessary to ensure compliance with the most important provisions of the Listing Rules, and what those “teeth” should be. HKEx does not have statutory powers of investigation. It does have contractual powers to require listed companies and directors to cooperate, but these do not extend to other persons who may have relevant information. Further, the range of disciplinary measures available to HKEx in relation to Listing Rule breaches is confined to public censures, statements of criticism, disqualification of individuals as directors of Hong Kong-listed companies, denial of the Exchange’s facilities to issuers and the “cold shoulder” for professional advisers. The Listing Rules do not at present provide for fines, although there is no reason in principle why the SEHK should not consider amending the rules to introduce a limited contractual fining power (as happens in some other markets). HKEx staff conduct inquiries into potential breaches of the Listing Rules and take appropriate action (subject to the foregoing limitations on investigation power and sanctions). Whenever HKEx staff uncover a potential breach of statutory provisions, they immediately notify the SFC, who will decide whether to undertake an investigation under the SFO.

12. **Deficiencies of Existing Powers and Sanctions** - The present powers and sanctions available to HKEx have proved adequate to ensure compliance with the Rules by the vast majority of listed companies and directors in the vast majority of situations which arise. Most such companies and their directors and controllers value their reputations and their access to the SEHK market. However, a small minority of unscrupulous directors and company controllers have not been deterred from activities designed to enrich themselves at the expense of public shareholders. Cases which have reached public attention frequently involved alleged fraud or theft (which already carry criminal sanctions). However, they also generally included misrepresentations in prospectuses, circulars and other listing documents.

13. **Absence of Statutory Requirements** - As pointed out in the Consultation Document, the principal deficiency of the present listing regime is the limited nature of the statutory obligations of listed companies. This results in excessive reliance being placed on the non-statutory Listing Rules and the limited investigative and sanctioning power of the SEHK. The current absence of statutory requirements for listed companies, particularly in the areas of financial reporting, continuous disclosure and connected transaction disclosure, has led to the perception that the Listing Rules need sharper “teeth” and to calls that “statutory backing” should be given to the Listing Rules. In fact, the weakness in Hong Kong’s regulatory framework does not lie in the content of the Listing Rules or the powers of the SEHK, but in the lack of relevant statutory provisions.

14. **Statutory Civil Liability** - At present, there are virtually no civil actions by shareholders in cases of abuse by majority shareholders. Civil actions by shareholders can play an important role in the policing of securities markets. A workable system of statutory civil liability would reduce the existing absolute reliance on regulators. Institutional shareholders can also play an important role in the protection of shareholders generally, as they are doing increasingly in the US and UK. While these issues are not the topic of the current Consultation Document, these are areas where the present regulatory regime remains in need of improvement.

IV. STRENGTHS OF THE PRESENT REGULATORY REGIME

15. **Success of Present System** - Before contemplating radical change to the present listing regime, HKEx believes it is important also to consider its strengths. As noted in the Consultation Document, under the three-tier system and existing institutional arrangements Hong Kong has established its position as one of the world's leading equity markets and the premier international capital formation centre for China. Since the listing function was delegated to the SEHK in 1991, the Exchange has built up and maintained an experienced professional management team. The Listing Committee has proved itself to be a highly effective means for ensuring that the rules are applied in a practical manner, with understanding of business operations and practices. The Listing Rules have been upgraded to international standards and continue to be amended to keep up with these standards as markets evolve. The SEHK played the lead role in the 1990's in developing Hong Kong as a listing venue for Mainland issuers. HKEx continues in this role and remains the body which is best equipped and positioned to market and promote Hong Kong as a capital formation centre to attract international issuers, including particularly Mainland enterprises.
16. **Growth of the Market** - The market capitalisation of all Mainland companies (that includes H share, Red Chip and Mainland Private Enterprise companies) now (as at 31/12/2003) amounts to HK\$1,695,056 million. Total market capitalisation has risen from HK\$949,171 million in 1991 to HK\$5,547,848 million at the present time (as at 31/12/2003). The amount raised annually in new listings has risen from HK\$6,952 million in 1991 to HK\$59,141 million in 2003. During the same period, fund-raising by way of further issues by listed issuers has risen from HK\$32,505 million to HK\$152,516 million. Turnover of the Exchange has risen from HK\$299,147 million in 1989 to HK\$2,583,830 million in 2003. According to HKEx's Cash Market Transaction Survey 2001/2, participation by international institutional investors now accounts for approximately 35% of turnover.

17. **Reform is Ongoing** - These facts do not suggest that the existing regulatory system has inhibited market development or failed Hong Kong in some way. Nevertheless, this does not mean that HKEx considers there is no scope for improving our current listing regime. Securities regulation is constantly changing in response to emerging issues and to embrace evolving best practice, technology and product innovation. Regulation must also respond to local circumstances (e.g. the listing of PRC enterprises and the re-domiciling phenomenon).

V. SOLUTIONS TO ABSENCE OF STATUTORY REQUIREMENTS

18. **Statutory Listing Rules Are Undesirable** - There appears to be a widespread consensus that making the whole of the Listing Rules statutory is neither desirable nor practical. Most of the Listing Rules constitute requirements which relate to the operation of a marketplace and the companies and products which are traded on it. Markets are constantly evolving and the Listing Rules need to be flexible enough to adapt to changes in market practice and the introduction of new products. This would be difficult if the Listing Rules were statutory. Statutory rules would also be subject to more legalistic interpretation and recourse to the Courts, which would fundamentally change the nature of the regulatory process. In the vast majority of overseas markets, the listing rules are not statutory but are administered by the exchange that owns and operates the marketplace, and they cover matters not addressed in the statutes or which go beyond the minimum statutory requirements.
19. **Statutory Backing for Core Requirements** - However, there are certain key provisions (from the point of view of investor protection) which in most overseas jurisdictions are found in law, as well as in the listing rules of the relevant exchange(s). The most important of these provisions, whose enactment in law is advocated by HKEx, are:
- (a) the financial reporting obligations of all listed companies, regardless of where they are incorporated; these should include the basic contents of annual and interim financial statements in accordance with specified accounting standards, which should be tailored to the nature of the issuer and its securities and, where appropriate, accompanied by a comprehensive management discussion and analysis (“MD&A”). The obligations should also specify the deadlines for disclosure, the extent of involvement of an auditor to audit or review the financial reports and the requisite standing of the auditor.
 - (b) the obligations of listed companies, regardless of where they are incorporated, to disclose on a timely basis material information in respect of significant corporate transactions and any other price-

sensitive information including the obligation, in particular, to disclose connected party transactions above a de minimis threshold.

The extent to which the obligation to seek prior disinterested shareholder approval of connected and other major transactions should be in the law as well as the Listing Rules is a matter for further consideration by the Government and others; the Standing Committee on Company Law Reform (“SCCLR”) has already made certain proposals in its consultation document of June 2003 aimed at safeguarding the position of minority shareholders, but this is limited to shareholder civil action.

20. **HKEx Supports Key Requirements in Primary Legislation** - HKEx has advocated, both publicly and in its submissions to the Expert Group and the SCCLR, that the above core disclosure obligations should be enacted as primary legislation in the SFO, accompanied by statutory penalties for breaches of these obligations.

One way to increase the range of sanctions available is to make intentional and reckless contraventions of the proposed new statutory obligations subject to criminal sanctions (ultimately imprisonment) and introduce a statutory administrative fining regime for breaches of a lower order. Under this regime, financial penalties would be imposed by a tribunal established for the purpose. A strict liability basis could apply, subject to a defence of demonstrating either that information disclosed was not material or that the directors believed on reasonable grounds that the information was true at the time it was disclosed; for non-disclosure, a defence would be formulated along the lines that the directors believed on reasonable grounds that the information not disclosed was not materially price-sensitive.

21. **Application to All Listed Companies** - An additional deficiency of the present listing regime is that certain statutory investor protection provisions contained in the Companies Ordinance do not apply to non-Hong Kong-incorporated companies, which constitute over 80% of companies listed here. The statutory obligations advocated by HKEx would apply to all Hong Kong-listed companies, regardless of where they are incorporated. There would be a

“level playing field”, with all listed companies being subject to the same statutory securities laws.

22. **Delisted Companies** - Placing these disclosure obligations in statute would also prevent such companies from evading them by the device of de-listing. Currently, if a company de-lists or is de-listed from the SEHK, the company and its shareholders fall into a statutory and regulatory vacuum. The Listing Rules no longer apply and (in the case of overseas companies) there is no statutory requirement in Hong Kong to provide shareholders with ongoing financial disclosure or prompt disclosure of other material information. The proposals made by HKEx would correct this anomaly.

23. **Jurisdictional Issues** – Conducting investigations and enforcing sanctions (even statutory ones) against directors and company controllers who reside outside Hong Kong is often difficult. Such action relies heavily on active help and co-operation from overseas regulators, who may not have the necessary powers or resources. In some cases there are also legal constraints (e.g. lack of extradition arrangements). Improved arrangements for securing the co-operation of overseas authorities and courts in relation to enforcement are also important.

VI. CONFLICTS OF INTEREST

24. **Existing Safeguards** - Conflicts of interest have repeatedly been cited as a reason why HKEx should relinquish administration of the Listing Rules. This was a recurrent theme in the Expert Group report. Paras 3.9 to 3.14 of the Consultation Document deal with this subject and point out that a very extensive set of safeguards exists in both the law and the MOU to address all significant types of conflict which could arise. A full list of these safeguards is contained in Annex B to this submission. They go well beyond the measures recommended in 2000 by the International Organisation of Securities Commissions (“IOSCO”) to deal with this issue in the context of exchange demutualisation. They include a specific power in the SFO for the SFC to give directions to HKEx if it considers that a conflict of interest has arisen. The existence of these safeguards was ignored in the Expert Group report and has been largely ignored in the public debate which has accompanied and followed it. HKEx welcomes the recognition given in the Consultation Document to these safeguards.
25. **Perception** - Nevertheless, conflicts remain a constant theme of public discussion. They are still cited as a potential objection to Models B and D in the Consultation Document. HKEx therefore feels it necessary to address this matter in some depth.
26. **No Evidence that Existing Safeguards are Inadequate** - Conflicts of interest are an ever-present feature of regulatory work, whether carried out by a statutory or non-statutory body. Managing conflicts is not a new issue. What matters is that adequate checks and balances exist to prevent conflicts of interest leading to abuse, and that the processes are managed with professionalism and integrity. Prior to the events leading up to the appointment of the Expert Group, the issue of conflicts was not the subject of professed public concern. No evidence has been adduced at any time that the present safeguards are inadequate or are not working. None of the audits of HKEx’s listing function by the SFC or ICAC has identified any case of inappropriate decision-making by either the Listing Committee or the Listing Division as a result of any conflict. Nor has the SFC voiced informally

concerns of this nature. If such concerns had arisen, the SFC has extensive powers to ensure corrective action.

27. **HKEx Has No Incentive to List Low-Quality Companies** - The allegation has been made against HKEx in the Expert Group report that HKEx's desire to maximize listing fee revenue has resulted in a failure by the Listing Committee and/or Listing Division to reject the applications of companies whose shares subsequently performed badly or attracted low liquidity or failed to interest international investors or which (in a few cases) became a source of corporate irregularities or alleged fraud after listing. The Expert Group's allegation is not substantiated by evidence.
28. **Enlightened Self-Interest Favours Quality** - HKEx considers the above allegation to be completely misconceived. Reasons for this include the following:
- (a) **Independent Listing Committee** - Listings are approved by the Listing Committee, whose 25 members have been appointed via a process over which the SFC has an equal measure of control to that of HKEx and who (with the sole exception of the HKEx CEO) have no interest in HKEx's profitability.
 - (b) **No Commercial Interest in Poor-Quality Companies** - HKEx has no commercial interest to list poor-quality companies or companies that are likely to be a source of corporate irregularities. The opposite is the case. HKEx's overriding concern is to maintain the quality of its market and its "brand", which is what attracts investors, and therefore listings, to the Hong Kong market. Listing unsuitable companies for the short-term benefit of some additional listing fees makes no sense if such listings tarnish the HKEx brand. Moreover, the financial interest of HKEx (which in any case does not prevail over its statutory public interest duty) is in profitability, not revenue for its own sake. Processing IPO applications from marginal companies (which are normally smaller ones), as well as regulating them subsequently, can absorb a disproportionate amount of resources in relation to the

revenues which they generate. In addition to reputational damage to the market, such listings are particularly unprofitable for HKEx if the companies concerned end up causing regulatory problems.

Therefore the enlightened self-interest of HKEx is to favour quality and avoid listing companies which tarnish its brand.

29. **Allocation of Resources to Listing Regulation** - A slightly less contrived form of potential conflict is that between HKEx's profit motive and the need to allocate sufficient resources to the listing regulatory function. However, again there is no evidence that HKEx has failed to devote adequate resources to regulation. Nor has the Expert Group or the SFC, or anyone else, alleged this. Numerous mechanisms exist to ensure that the regulatory function is properly resourced, including:

- (a) the overriding statutory public interest duty of HKEx, backed up by the fact that half the Board of HKEx is appointed by Government;
- (b) a specific provision in the SFO requiring the SEHK to ensure that the listing function is staffed with competent personnel;
- (c) the provision in the MOU which requires that HKEx ensure that the staffing of the Listing Division is sufficient to discharge its responsibilities;
- (d) the periodic audits of HKEx's listing function carried out by the SFC;
- (e) the ability of the SFC, by virtue of its extensive statutory powers, to ensure corrective action if it perceives that HKEx's regulatory resources are inadequate.

In fact the total staff headcount of the Listing Division has increased from 54 in 1991 to 85 in 1994 and then 110 in 2003. All the objective evidence is that HKEx has devoted the necessary resources to listing regulation since it became the front-line regulator in 1991.

30. **Conflicts are Not the Problem they Have Been Made Out to Be** - For all these reasons, HKEx believes that the perception that conflicts of interest within HKEx either have prejudiced or could prejudice the regulatory process is unjustified. There is no basis in fact for the concerns expressed.

VII. “SHARED REGULATION”

31. **Shared Responsibility** - The perceived undesirability of “shared regulation” (as it is called in the Consultation Document) is the other main reason which is sometimes adduced in favour of concentrating all aspects of listing regulation within the SFC. A concern reflected in the Consultation Document is that if two bodies are involved, there is a risk of regulatory gaps or overlaps emerging, leading to unclear accountability. HKEx would therefore like to address this matter also in some detail.

32. **Some Regulatory Overlap is the Necessary Concomitant of Checks and Balances** - In HKEx’s view, there is an inherent “trade-off” between regulatory overlap and the maintenance of checks and balances to prevent the arbitrary exercise of power, and to ensure fairness in the administration of the regulatory requirements. A key feature of the “three-tier” system is the SFC’s role as “watchdog”, overseeing HKEx’s and the Listing Committee’s performance of their listing functions and ensuring that these are properly resourced and efficiently and fairly carried out. If the watchdog became the administrator of the Rules, there would be no watchdog any more. Overlap might be eliminated (whether or not that is a good thing), but most of the checks and balances within the present three-tier structure would be lost. If all listing functions were concentrated in one body, the present three-tier system would become in this area a two-tier system, or in fact a one-tier system (unless Government acquired personnel with the necessary experience to perform a watchdog role analogous to that performed by the SFC over HKEx). Concentration of power and the removal of checks and balances also inevitably increase the risk of corruption.

33. **Shared Regulation is the Normal International Model** - Shared regulation in relation to listing matters is a feature of securities markets in the vast majority of overseas jurisdictions (the UK is the only significant exception, and only due to recent historical factors which have no parallel in Hong Kong). The role of an exchange, being closer to its own market, is to administer the listing rules on a day-to-day basis and, if breaches are detected, to conduct inquiries and take disciplinary action where non-statutory offences are found.

Where the exchange's inquiries reveal possible breaches of statutory provisions, the matter is reported to the statutory regulator. The primary role of the statutory regulator is to set key disclosure standards and to police statutory provisions. The exchange's listing rules may well include requirements which go beyond those set out in or derived from statute. "Shared regulation" of this kind is the international norm and has worked well in most jurisdictions. Annex C describes the arrangements which prevail in North America and Singapore.

34. **Past Problems are Not Related to Structure** - HKEx agrees that there have been occasions in the past where a lack of clarity as to whether HKEx or the SFC was responsible for making particular decisions has led to confusion and frustration among market participants. HKEx does not agree that this is the unavoidable consequence of having two bodies involved. HKEx believes past problems have been in large part due to concerns about the extent and scope of their respective roles resulting in a degree of friction at the operating level between HKEx staff involved in the administration of the Listing Rules and SFC staff engaged in a monitoring role. HKEx believes these are "people problems", not structural problems, and that they are eminently soluble. Indeed, HKEx believes they have recently been declining in frequency and intensity. Improved communication on issues of mutual interest should help reduce the occurrence of these problems.
35. **"Shared Regulation" Should Help to Close Regulatory Gaps** - If regulatory "gaps" were to emerge as a result of the involvement of two bodies, that would certainly be undesirable. HKEx is not aware of any such gaps hitherto. In principle, the involvement of two bodies should make the emergence of gaps less, rather than more, likely. The involvement in monitoring listed company conduct of the body which owns and operates the market, with its generally more market-attuned personnel, should add value to that of the statutory regulator, with its sensitivity to the statutory framework and the law. This has certainly been the experience in other markets, where this kind of overlap is generally perceived to confer net regulatory benefits. Indeed, there have been situations in Hong Kong where it proved easier for HKEx than for

the SFC to obtain information needed in investigations involving persons outside the territory. HKEx therefore believes that shared regulation does not need to be seen as a “problem”. Indeed it should be a virtue.

VIII. THE FOUR MODELS

36. **Analysis of the Models is Partial** - As the Consultation Document concedes, the four models set out in paras 3.20-3.41 are only outlined briefly and are not necessarily the only ones available. Their benefits and shortcomings are also analysed quite briefly. There are many important details which are not spelled out – for example the role and location of the Listing Committee in each case and the impact which each model would have on the “three-tier” regulatory structure, as well as the impact each would have on HKEx’s ability to fulfil its obligation to maintain an orderly and informed market. Model B is not mutually exclusive with Model D. HKEx’s comments on each model are set out below.

Model A: Transfer of Listing Functions to a New Division Set up Under SFC

37. **Model A Would Destroy Existing Checks and Balances** - This model would effectively destroy the checks and balances inherent in the three-tier regulatory structure. If there is no watchdog, an entire layer of oversight and accountability in listed company regulation is lost. A single regulator might sound superficially appealing in terms of simplicity and avoidance of the “problem” of shared regulation. However, any gain of this kind (if it is a gain) has to be weighed against the likely long-term consequences for Hong Kong of instituting a system dominated by a single powerful statutory regulator, without the independent oversight built into the three-tier structure.
38. **Present Checks and Balances** - At present, the Listing Committee proposes amendments to the SEHK Listing Rules (after public consultation) but they cannot be implemented without approval from the SFC. The Listing Rules are administered on a day-to-day basis by the Listing Division, but decisions in relation to new listings and disciplinary cases (particularly where interpretation of the Rules is required) are made by the members of the Listing Committee, who are independent and experienced market professionals. The whole process is overseen by the SFC. This means that those who make the day-to-day decisions know that any bias or laxity on their part is likely to be detected. This provides comfort to market participants that the system is both

efficient and fair and that the powers of the SEHK and the Listing Committee are unlikely to be abused.

39. **Concentration of Functions and Powers in a Single Body Would Create a Structural Bias in the System** - If the roles of proposing and approving the Listing Rules, administering and interpreting them, prosecuting breaches and adjudicating in such cases, were all amalgamated into a single body, a new set of conflicts of interest would arise. A structural bias in the system would also be created which, HKEx believes, would cause concern among market participants. Faith in and respect for a regulatory system depends on the knowledge that it is possible for market participants to challenge in good faith the decisions of the regulator, without fear of retribution and with confidence that they will receive a fair hearing. Recourse to the Courts (even if this is legally feasible) is seldom a practical option for companies in the vast majority of real-life situations. There is also a natural reluctance to challenge in Court a regulator which has extensive statutory powers. If the regulator knows that his decisions are difficult or impossible to challenge, there is an inevitable risk that such decisions could become arbitrary or high-handed. Such a perception would affect the attractiveness of the Hong Kong market to both issuers and intermediaries.
40. **Constitutional Implications of Model A** – HKEx believes there is also a serious constitutional problem inherent in Model A which does not appear to have been addressed in the Consultation Document. If the listing functions are performed by a division of the SFC, the relevant Rules would need to be made by the SFC. This means that they would necessarily become subsidiary legislation because, under the terms of section 3 of the Interpretation and General Clauses Ordinance (“IGCO”), any rule made by a statutory body is subsidiary legislation and would be required to be negatively vetted by Legco. The only way to avoid this would appear to be for Legco to pass a special law exempting the Listing Rules from this constitutional requirement, which Legco members would (HKEx believes) be loath to do. If the Rules take the form of subsidiary legislation, this would be likely to make the issue of a new set of Listing Rules a major and potentially controversial and politically-

charged exercise, absorbing a large amount of administrative resources and legislative time. Despite this cost, it would be unlikely to lead to any improvement in the substance of the Listing Rules. It would also make the Rules cumbersome to amend and subject to legalistic interpretation, which would profoundly influence the way they affect the market.

41. **Circumvention of Constitutional Requirements** - Although various means were discussed in the Expert Group report of trying to circumvent this legislative requirement, including the issuance by the SFC of a code of conduct or guidelines instead of rules, HKEx does not believe that any of these ideas would work. As the Consultation Document points out, codes or guidelines have no statutory force and would therefore be likely to diminish rather than enhance the “teeth” of the Rules. Moreover, the Listing Rules are (in the main) a set of prescriptive obligations, not guidelines. Mandatory or prescriptive requirements cannot be formulated as anything other than rules.
42. **Delegation of Legislation Role** - The idea (which has also been floated) of enshrining in primary or subsidiary legislation certain general principles, and then leaving the SFC to issue codes or guidelines to determine their interpretation, would require a wholesale re-formulation of the Listing Rules almost from scratch. This would be an even more massive and expensive exercise (both in money and time) than trying to turn the present Listing Rules into law. It would probably take years and give rise to much controversy.
43. **Financial Implications of Model A** - There is a risk that the overall cost of listing regulation would rise significantly. HKEx would continue to charge fees (as all exchanges do) for access to its market and the other facilities which HKEx provides. It is noteworthy that when the UKLA was transferred from the London Stock Exchange to the Financial Services Authority in 2000, two thirds of the listing fee revenue was retained by the LSE as a market access fee.

Model B: Transfer of Listing Functions to a new HKEx subsidiary

44. **A Similar Model Proposed by HKEx** – One of the perceived weaknesses in the present listing regime, which was recognized by HKEx when making its submissions to the Expert Group, is a perceived lack of clarity about the

reporting lines and accountability of the Listing Division. A possible solution suggested by HKEx was to house the listing function in a separate subsidiary company with an independent board, whose sole responsibility would be to ensure the proper performance and resourcing of the listing regulatory function. The members of the subsidiary's board would be appointed by Government or via a similar process to the present Listing Committee (i.e. with both the SFC and HKEx having veto power). The staff of the Listing Division would become employees of the subsidiary, with their primary reporting line to its board. Under this arrangement, the board of the subsidiary would have direct control over the personnel of the Listing Division. The Listing Committee would be retained and expanded with a higher proportion of investor representatives. The present appeal mechanism (whereby decisions by one group of Listing Committee members are appealed against to another group of members of the same Committee) would also be improved.

45. **Advantages of a Separate Subsidiary** - In addition to removing any perceived lack of clarity about reporting lines and accountability, the higher degree of autonomy of the listing function inherent in this model would address the perception of conflicts of interest. It should also enhance transparency concerning the activities and costs of the Listing Division and strengthen the checks and balances within the system. The present participation by experienced practitioners in decision-making would be retained. HKEx believes this model is both viable and compatible with Model D.
46. **Adequacy of Resources** - The “problem” of ensuring that adequate resources are devoted to listing regulation is not a real one. As mentioned in para 29 above, there is an array of existing statutory and other arrangements which address this issue. Under the separate subsidiary proposal of HKEx, there is also an independent board of the subsidiary, one of whose main functions would also be to ensure that resourcing of the subsidiary is adequate in quantity and quality. The SFC would no doubt be influenced by the views of this board. If the main board of HKEx formed different views, when considering the proposed expenditure of the subsidiary, it would no doubt

discuss these with the subsidiary board and with the SFC. Against the above background, it is inconceivable in practice that the HKEx Board would starve the subsidiary of resources which both the subsidiary's board and the SFC considered necessary.

47. **The “Duplication” Issue Has Been Addressed** - The possible objection to this model on the grounds that it does not eliminate duplication (“shared regulation”) has been addressed in paras 31-35 above.

Model C: Transfer of Listing Functions to a New Statutory Authority Independent of both SFC and HKEx

48. **Model C** - HKEx does not favour this model. It would involve creating an additional regulatory body and still contain many of the drawbacks of Model A.

Model D: Expanding the “Dual Filing” System

49. **Model D** - As far as can be inferred from the brief description in the Consultation Document, Model D retains the present division of functions between the SFC and HKEx, except that the SFC would be the ultimate enforcement agency for any new statutory obligations. It appears that the vetting of prospectuses would continue to be carried out as at present. As mentioned in the Consultation Document, this model would cause much less disruption than either Model A or Model C.
50. **“Dual Filing”** - The dual filing mechanism addresses statutory regulation of listed companies in the secondary market indirectly. While the continuous disclosure obligations in the Listing Rules remain non-statutory, the documents are filed with the statutory regulator who has statutory investigation powers and can prosecute listed companies or directors for any false or misleading disclosure which can be shown to have been made knowingly or recklessly. However, the “dual filing” system stops short of widespread international practice, which generally includes affirmative on-going statutory disclosure obligations, in addition to any non-statutory requirements imposed upon listed companies by the relevant exchange. The

proposed core statutory disclosure obligations discussed in para 19 above would impose a positive obligation on listed companies (and other public issuers) to prepare and file financial statements and public announcements of any information necessary to ensure that a fair and informed market is maintained. Failure to file financial statements (or failure to meet the prescribed standards of disclosure) or to issue a timely public announcement in respect of price-sensitive information would be grounds for action by the SFC.

51. **Interaction With the Listing Rules** - HKEx suggests that the proposed core statutory disclosure requirements would be the minimum expected standards. The Listing Rules in this area would be harmonized with the statutory requirements to avoid any conflict. The existing Listing Rules would remain substantially intact and would continue to govern areas not addressed in the core statutory obligations. The Listing Rules would provide additional requirements, both mandatory and non-mandatory, including codes of best practice. It is common in other jurisdictions for stock exchanges to have an additional set of requirements for their listed companies above and beyond the minimum disclosure that is required under the local securities law. Another possibility would be to make conduct in compliance with the Listing Rules a safe harbour from breaches of statutory obligations. This would allow the obligations to be framed in clear and simple terms.
52. **Role of HKEx** - After introduction of the proposed core statutory disclosure requirements, the SEHK would perform substantially the same role in connection with new listings and ongoing regulation of listed companies that it performs today. The Exchange would not disappear from the enforcement process but, as a front line regulator of market activity, would continue to play an active role in administering the Listing Rules, vetting documents and conducting investigations and taking disciplinary action in relation to breaches of the Rules. The responsibility for formal statutory investigations and enforcement of statutory disclosure obligations would rest with the SFC.
53. **Role of SFC** - The SFC would continue to monitor the HKEx listing function and to carry out audits, which should take place on a regular basis and address

prescribed matters. The SFC would be responsible for investigating breaches of the new statutory requirements and bringing enforcement proceedings where appropriate. The SFO has already enhanced the SFC's investigation powers, particularly its ability to seek records and documents from a listed company's auditors, bankers, transaction counterparties and persons in possession of such records and documents. The proposed new statutory provisions would include penalties for breaches of the new statutory obligations, which should be levied by an appropriate designated tribunal or the courts, depending on whether the relevant penalties are civil or criminal (see para 20 above). This should result in better compliance with, and more effective enforcement of, disclosure by listed companies. These enforcement powers, allied with other graduated responses to issues of non-compliance (including further market and issuer education) from the SFC and the Exchange, should create a more positive approach towards compliance by issuers and their directors.

54. **Transparent Definition of Roles** – The SFC, Government and HKEx would establish a joint working group to draft a “work flow chart” which would define in detail, in a manner transparent to the market, the roles of each organisation, including their roles in relation to enforcement.
55. **Improvements to Model D** – HKEx believes that there are, however, certain modifications or elaborations of Model D which would improve the present system by clarifying roles and accountability and enhancing operational efficiency. These are:
 - (a) The role of the Listing Committee would be clearly defined as being to consider and make decisions on listing applications and cancellations of listing status. The Listing Division would make first instance decisions on all other listing matters (for example, listing approval for further issues of shares, interpretations of the Listing Rules and granting of waivers post-IPO) under the power delegated by the Listing Committee. The composition of the Listing Committee would (as in Model B) be altered to improve the balance between issuer and investor representatives.

- (b) There would be a separate Listing Policy and Appeals Committee (“LPAC”), nominated in the same way as the present Listing Committee, which would make decisions on listing policy matters (including the content of Listing Rules to be made by the SEHK) and would hear appeals against all decisions of the Listing Division on non-disciplinary matters and against decisions of the Listing Committee on individual listing applications and de-listings. The agenda for meetings would be set by the Chairman in consultation with members of the Committee and the Head of Listing.
- (c) There would also be a Disciplinary Appeals Committee (“DAC”), similarly nominated and chaired by a legally-qualified person with market experience, to hear appeals against decisions of the HKEx Executive in disciplinary cases.
- (d) An independent committee of the Board of HKEx would be established, consisting predominantly of public interest directors (and excluding the HKEx CEO) which would be charged with reviewing the performance of the listing function and ensuring that this is properly resourced. The role of this committee would include reviewing the annual budget of the Listing Division, the annual review report by the SFC (see (e) below) and quarterly reports from the LPAC and Listing Committee (which should include reports on appeal cases). This independent committee would report its findings and make recommendations to the full Board, with a view to ensuring that the latter is able to discharge its responsibilities effectively. The findings of the independent committee would also be available to the SFC.
- (e) A specific provision would be added to the MOU to the effect that the SFC will carry out an annual review specifically designed to satisfy itself concerning the quantity and quality of resources allocated to the Listing Division. The result of the SFC’s review would be reported to the independent committee of the HKEx Board mentioned above. Enhancements would also be made to the terms of reference of the SFC’s periodical audits of the listing function, to provide clarity of

purpose and of the methodology and the form of opinion to be expressed.

- (f) HKEx will review its policy for dealing with bona fide complaints by listed companies and other market participants about the handling of particular listing-related cases, and will consider the creation of a formalized mechanism to ensure that such complaints receive proper attention.
- (g) In addition to the frequent meetings that already take place between the chairmen of the SFC and HKEx to discuss issues of mutual interest, a further series of regular meetings involving the Chairmen of the Listing Committee, LPAC and the Executive Director of the Corporate Finance Division of the SFC would provide an opportunity for feedback on the Listing Unit's performance (without the Executive present) and to assess the adequacy of the support given to the LPAC and the Listing Committee by the Listing Division.

The roles of the Listing Committee, LPAC and DAC as set out in (a), (b) and (c) above are consistent with the proposals announced in July 2002, following agreement among FSTB, the SFC and HKEx, and could also be adopted under Model B.

56. **Conflicts of Interest** – Under Model D as described above, the theoretical potential conflict of interest between the commercial and regulatory objectives of HKEx would be resolved by
- (a) the overriding nature of HKEx's and the SEHK's public interest duty, reinforced by the presence on the HKEx Board of directors who are either appointed by Government to represent the public interest or approved by the SFC;
 - (b) the specific supervisory role performed by the independent committee of the HKEx Board described above;
 - (c) the provision that the adequacy of listing regulatory resources should be further assessed independently by the SFC.

As noted earlier in this submission, HKEx does not consider that conflicts of interest have in fact influenced listing policy or decisions in any way. The HKEx Board is very confident that, under the arrangements described in this submission, conflicts of interest would not affect either policy decisions or the allocation of resources to listing regulation. The independence of the regulatory function would also be enhanced in a clearly visible manner.

57. **Model D is Consistent with Most Major Markets** – This model should not (despite a suggestion to this effect in the Consultation Document) increase regulatory overlap by comparison with the present system. As noted above, it is consistent with the way exchanges and statutory regulators work together in most overseas jurisdictions.

58. **Incremental Change without Additional Costs.** Model D builds on the existing institutions, rather than seeking to impose radical change. HKEx would remain the frontline day-to-day regulator of listed issuers. There would be no need to convert all of the Listing Rules into legislation. The proposals would not impose any additional burden or cost on issuers, the great majority of which comply fully with their existing obligations. More effective tools would however be available for dealing with the minority of companies and insiders that abuse their access to Hong Kong's securities markets. The existence of the new statutory provisions should also widen the scope of civil liability for breaches of disclosure requirements and thus enhance the ability of investors to seek legal remedies for damages caused by misleading disclosure or other misconduct.

IX. VETTING OF PROSPECTUSES

59. **Transfer Order under SFO** - An important matter which is not discussed directly in the Consultation Document is the extent to which the SEHK should retain its present responsibility for vetting IPO and other prospectuses for compliance with the Companies Ordinance. The prospectus vetting function was originally transferred to the Exchange in 1991. This transfer was confirmed in 2003 in a Transfer Order made by the Chief Executive in Council under the new SFO. Under Model A, this function would appear to be taken over by the SFC. Under Model C, it would be performed by the proposed new statutory body. Under Models B and D, it would appear to remain with the SEHK (although the Consultation Document is slightly ambiguous on this point).
60. **Present Vetting Arrangements Function Well** - It is not evident why there needs to be any change from the present arrangements in respect of prospectus vetting. Under the dual filing regime, all materials filed with HKEx constitute statutory filings and the SFC already reviews their contents from a disclosure point of view. This avoids the necessity for companies to file prospectuses with two separate regulators and preserves the “one-stop-shop” approach which is one of the practical advantages of the present Hong Kong system. As mentioned in the Consultation Document, the dual filing regime appears to have been working satisfactorily since its introduction in April 2003. HKEx does not believe that present arrangements need to be disturbed. The SFC could (as it does today) review prospectuses of new listing applicants and pass on any concerns to HKEx, who would ensure that they are addressed. The SFC would thus be able to focus its resources on the “higher risk” IPO’s, so that there is additional scrutiny of these.
61. **Practice in Other Jurisdictions** - It is common in other jurisdictions for prospectus materials to be reviewed by both the statutory regulator and the relevant exchange. The former seeks to ensure compliance with statutory requirements (generally disclosure-related) and the latter with the listing rules of the relevant exchange (admission criteria, the background and reputation of the management and principal shareholders, compliance with the required

contents of listing documents, compliance with the rules for share option schemes, compliance with corporate governance requirements, etc.). In Singapore, the Exchange is responsible for reviewing prospectuses. In the USA, the SEC reviews registration statements which provide prospectus-level disclosure. An application is also made to the relevant exchange, accompanied by the draft registration statement, and exchange staff review the documents for compliance with the listing rules. In Canada likewise, both the commission and the exchange review the draft prospectus.

X. SUMMARY OF HKEX'S VIEWS

62. **HKEx Supports New Statutory Obligations** - HKEx supports the enactment in the SFO of the post-IPO financial reporting, disclosure and other obligations mentioned in para 19 above, including the enactment of proposals arising from the SCCLR's initiatives in respect of connected party transactions. The existing statutory disclosure requirements for prospectuses are already broadly in line with those of most other international markets. However, HKEx believes the two sets of existing prospectus requirements for listed companies in the Companies Ordinance need to be updated, consolidated and re-enacted in the SFO. We note that Government has acknowledged the need for an overhaul of the prospectus regime and that the process is already under way with the Companies (Amendment) Bill 2003. We also note that the SFC has stated its intention to undertake a comprehensive review of the prospectus regime. HKEx supports both of these initiatives.
63. **Statutory Sanctions** - Regarding the nature of statutory sanctions for breaches of the above new requirements, HKEx would support fines and the other penalties described in para 2.43 of the Consultation Document, provided they are administered by a Court or an appropriate designated tribunal, as proposed in para 20 above.
64. **Conflicts of Interest** - HKEx regards the existing statutory and other safeguards against conflicts of interest (whose existence and extent are not fully appreciated by many commentators) as more than sufficient. If additional safeguards are considered necessary, the measures outlined above either through the separate subsidiary proposal or enhancement of Model D would provide these, as well as enhancing the transparency, accountability and perceived independence of the regulatory function.
65. **Regulatory Structure and the Roles of SFC and HKEx** - Regarding the regulatory structure, HKEx favours Model D, with the modifications described in paragraph 55 above. Model B above would also be a viable model. Whether Model D or Model B is preferred, what goes into statute should be the same. The main reasons for HKEx's position are:

- (a) Model D builds on existing institutions which have served Hong Kong well and helped it to become a major financial centre. Both Models A and C would be highly disruptive and the introduction of either would be fraught with problems which are not addressed in the Consultation Document and which (in HKEx's view) would be extremely difficult or impossible to solve.
- (b) Model A would destroy the checks and balances built into the present three-tier structure, would result in an unwise and unhealthy concentration of administrative power, and would create a structural bias within the system making it difficult to challenge the regulator's decisions and potentially reducing the attractiveness of the Hong Kong market to issuers and intermediaries.
- (c) The perceived problems in "shared regulation" can be resolved satisfactorily within the present structure, as they are in the majority of other markets. They are a function of people and inter-organisational relationships, rather than structure. One of their principal causes is the paucity of statutory requirements for listed companies in Hong Kong. HKEx believes these relationships are already improving and there appears to be a consensus that the issue of statutory requirements needs to be addressed. HKEx will commit to co-operate fully and unreservedly with the SFC in making Model D above work smoothly.
- (d) For the reasons already mentioned, conflicts of interest within HKEx are not in reality the "problem" they have been made out to be by many commentators. The concentration of functions under Model A would create at least equally serious conflicts of interest between different elements within the SFC and would exacerbate structural bias.
- (e) Model D, as described above, solves a number of operational problems within the present structure. In particular it would permit the reporting lines and accountability of the listing function to be more clearly defined, the operation of the Listing Committee to be made more efficient, and the appeal mechanism to be rationalized and made more

independent. It would also enhance the mechanisms designed to ensure that the listing function is carried out efficiently and is properly resourced, as well as ensuring that the Board of HKEx is able to fulfil its responsibilities effectively.

- (f) The cost to Hong Kong in terms of administrative and legislative time and resources of attempting to implement Model A or Model C (not to mention the costs to the private sector) would be high, in return for little or no tangible benefit. The cost of the regulatory regime for issuers would also be likely to rise.

66. **Minority Shareholder Protection** – HKEx suggests that, if amendments to the SFO are to be made to provide for new statutory obligations, then the opportunity should be taken to review progress in enhancing the rights to fair treatment of minority shareholders and the legal remedies available to investors. The time and costs involved in undertaking civil litigation in Hong Kong at present make it impractical for an individual shareholder to pursue a case based on “unfair prejudice” or loss due to a misrepresentation in a listing document. Further, the cost rules in Hong Kong (where the loser is required to pay the costs of the other party) are a major disincentive to bringing an action. The power to conduct derivative actions for minority shareholders against a listed company is one proposal which might help redress this imbalance and, practical limitations accepted, one that HKEx supports. We note that, as a consequence of the recent consultation exercise arising out of Phase I of the SCCLR review, implementation of this proposal has been deferred. Consideration should also be given to establishing a statutory deemed reliance by shareholders on misrepresentations in listing documents.

XI. CONCLUSION

67. **Build on Existing Foundations** – The present system for regulating listed companies is generally accepted to have served Hong Kong well. There has been no experience which shows that fundamental change in the structure is necessary. The institutionalised checks and balances in the present “three-tier” system are of great value, especially in the Hong Kong context; they would be practically impossible to replace; to dismantle them would be likely to damage Hong Kong as a capital formation centre. The perceived lack of “teeth” in the Listing Rules is not a result of the present regulatory structure, but of a gap in the statutory framework. Hong Kong should update its statutory framework as proposed above through primary legislation, while leaving the basic organisational framework intact but making operational improvements as described in the modified version of Model D above.

**BRIEF SUMMARY OF THE CONTENTS OF THE LISTING RULES
OF THE STOCK EXCHANGE OF HONG KONG LIMITED (“SEHK”)**

1. **Statutory Basis for Listing Rules**: As an exchange company recognized under S.19 of the Securities and Futures Ordinance (“SFO”), HKEx is given (under S. 23) the power to make non-statutory rules for the listing of securities on the stock market operated by it. These rules and any amendment thereto are subject to SFC prior approval under S. 24 of the SFO. The SFC may also make listing rules under S.36 of the SFO and may provide for the cancellation of listing of a listed company if the SFC’s requirements are not met. Pursuant to the Securities and Futures (Stock Market Listing) Rules, which are subsidiary legislation under the SFO, listing applications (including prospectuses) and circulars and other documents must be filed with the SFC. The following is a brief summary of the contents of the 2 volumes of the Main Board Listing Rules, indicating where appropriate the nature of such rules (for example, operational, disclosure etc). References to “Chapters” and “Appendix” below refer to relevant chapters of and appendices to the Listing Rules.

The Listing Rules

2. **Chapter 1 (Interpretation)** deals with definitions and interpretation of the Listing Rules.
3. **Chapter 2 (Introduction)** contains general provisions relating to the background to and principles of the Listing Rules and HKEx’s news dissemination arrangements.
4. **Chapter 2A (Composition, Powers, Functions and Procedures of the Listing Committee, the Listing Appeals Committee and the Listing Division)** This chapter provides for the composition, powers, functions and procedures of the Listing Committee, the Listing Appeals Committee and the Listing Division. In particular, Chapter 2A makes it clear that the board of SEHK has delegated all of

its powers and functions in relation to listing matters to the Listing Committee. The Listing Committee (which comprises 25 members representing HKEx broker participants, listed companies, investors and other market practitioners, including investment banks, fund managers, accountants and lawyers) has in turn delegated most of these functions to the Chief Executive of SEHK (as defined in the Rules) and the Listing Division (for example, the task of interpreting, administering and enforcing the Listing Rules is performed by the Listing Division).

5. **Sanctions:** The sanctions available to the Listing Committee against listed issuers, their directors, senior management, substantial shareholders, professional advisers and sponsors for breach of the Listing Rules include:
- (a) issuing a private reprimand;
 - (b) issuing a public statement involving criticism;
 - (c) issuing a public censure;
 - (d) reporting the offender's conduct to the SFC or another regulatory authority;
 - (e) banning a professional adviser from representing a specified party before the Listing Division or Listing Committee for a stated period;
 - (f) requiring a breach to be corrected within a specified period, including, if appropriate, the appointment of an independent financial adviser to minority shareholders;
 - (g) (for directors of a listed issuer) stating publicly that the retention of the director in office is prejudicial to investors' interests;
 - (h) where statement under (f) has occurred and the relevant director remains in office, suspend dealings or cancel the listing of the securities of the relevant company;

- (i) prohibiting market participants from acting for an issuer who has wilfully or persistently failed to comply with its responsibilities under the Listing Rules.

Requests for decisions in writing must be made within 3 days of the relevant decision.

- 6. **Chapter 2B (Review Procedure)** This sets out the review procedure whereby the Listing Committee, as an independent review body, has the right to review any decision made by the SEHK Chief Executive, the Executive Director of the Listing Division or the Listing Division and to endorse, vary, modify or reverse such decision. In addition, the Listing Committee has the right to impose directions, regulations or restrictions on the Chief Executive of SEHK, the Executive Director of the Listing Division and the Listing Division as to how they carry out their delegated authority.
- 7. **Appeals:** A company may appeal a decision made by the Listing Division. The appeals process is as follows:
 - (a) the new listing applicant or listed company may apply to have any ruling of the Listing Division reviewed by the Listing Committee (“first review”);
 - (b) where the Listing Committee rejects a listing application or endorses, modifies or varies a Listing Division’s ruling, the aggrieved person may apply for the decision to be referred to the Listing Committee (“the Listing (Review) Committee”) again for a second review (“second review”). The decision of the Listing (Review) Committee will be binding and conclusive, except if the new listing applicant has been rejected solely on basis of unsuitability for listing; and
 - (c) the Listing Appeals Committee may review decisions made by the Listing Committee and the Listing (Review) Committee, on matters such as rejection of new listing applicants, rejection of sponsors, rejection of a request to lift a suspension of dealings, and suspension of dealings or

cancellation of listing. The Listing Appeals Committee's decisions in these cases are conclusive and binding.

8. **Chapter 3 (Sponsors, Authorised Representatives and Directors)** Sponsors: New listing applicants must be sponsored by an intermediary acceptable to SEHK. SEHK will not accept as sponsor an intermediary that it considers will not give impartial and competent advice to the applicant. The sponsor is required to assist the applicant in its listing preparations (including liaising with SEHK) and must satisfy itself that the issuer is suitable for listing and that its directors understand their obligations as directors of a listed issuer. The sponsor is required to comply with the Model Code for Sponsors (contained in Appendix 9) which requires, among other things, that the sponsor should have adequate resources and experience to fulfil the role and should satisfy itself that it is capable of providing impartial advice before agreeing to accept the role of sponsor.
9. **Directors and authorized representatives:** Chapter 3 requires directors of listed companies to fulfil fiduciary duties and duties of skill, care and diligence of at least the standard required under Hong Kong law and to satisfy SEHK that they have the character, experience, integrity and competence to be directors of a listed company. Chapter 3 also contains requirements relating to independent non-executive directors and stipulates that listed company directors must comply with the Model Code for Securities Transactions by Directors of Listed Companies (set out in Appendix 10) and with any guidelines for boards of directors issued by SEHK from time to time. Chapter 3 also requires every issuer to appoint two authorised persons to act at all times as the principal point of contact with SEHK.
10. **Chapter 4 (Accountants' Reports)** contains the detailed disclosure requirements for accountants' reports on the profit and loss statements, balance sheets and other financial information to be included in new listing prospectuses and shareholder circulars.
11. **Chapter 5 (Valuation of and Information on Properties)** contains the requirements concerning the basis of valuation of, and descriptive information relating to, property where independent valuation reports are required to be

included in new listing prospectuses and shareholder circulars for particular categories of corporate transactions involving property.

12. **Chapter 6 (Suspension, Cancellation and Withdrawal of Listing)** contains the provisions enabling SEHK to suspend, cancel or withdraw listings under certain circumstances, e.g. failure to comply with the Listing Rules, insufficient proportion of securities in public hands, or unsuitability for continued listing.
13. **Chapter 7 (Methods of Listing)** sets out the principal methods of listing a company and its securities. These include offers for subscription, offers for sale of existing securities, placings, introductions, rights issues and open offers.
14. **Chapter 8 (Qualifications for Listing)** sets out the qualifications for listing that must be met for an applicant to be considered for listing. These basic entry criteria include the following requirements:
 - (a) that the company be duly incorporated or established in its home jurisdiction and be suitable for listing;
 - (b) that the company has an adequate trading record over a 3 year period with substantially the same management and meets a minimum profit test over the same period;
 - (c) that there will be an adequate market in the securities to be listed;
 - (d) that a minimum percentage (generally 25%) of the issuer's securities must be held in public hands at all times and there must be a minimum number of genuine public shareholders;
 - (e) that the company have a minimum market capitalisation of HK\$100 million of which at least HK\$50million must be held by public shareholders; and
 - (f) disclosure-based provisions regarding treatment of conflicts of interest and competition with controlling shareholders.

Additional specific requirements for mineral companies seeking a listing are set out in Chapter 18. In addition, Chapters 19 and 19A set out additional requirements for Bermuda and Cayman Island issuers, and PRC issuers respectively. It should be noted that compliance with the requirements under Chapter 8 does not ensure listing approval; SEHK retains the discretion to impose additional requirements and to accept or reject listing applications.

15. **Chapter 9 (Application Procedures and Requirements)** contains the procedures and documentary requirements for the listing application process. The Listing Division vets prospectuses to ascertain if all requirements have been met and full disclosure made. The Listing Division reserves the right to delay a Listing Committee hearing date if it considers that the prospectus is not in a sufficiently advanced state or that its comments are not being satisfactorily addressed or where documents have not been filed within the relevant timeframe.
16. **Chapter 10 (Restrictions on Purchase and Subscription)** contains restrictions on preferential treatment of employees or past employees of a company and restrictions on directors and existing shareholders in relation to allocation of securities under a new listing or a placing (Appendix 6 sets out the requirements relating to allocation of securities under a placing). Chapter 10 also contains SEHK's requirements governing on-market share repurchases by listed companies, disposal of shares by controlling shareholders following a new listing and a requirement for public offers to ensure fair and equitable distribution to the public.
17. **Chapter 11 (Listing Documents)** refers to the following methods of listing that are required to be supported by a listing document, and the contents of listing documents:
 - (a) offers for subscription;
 - (b) offers for sale;
 - (c) placings of a new applicant or by a listed company of securities of a class not yet listed;

- (d) introductions;
- (e) rights issues;
- (f) open offers;
- (g) capitalisation issues; and
- (h) exchange or substitution of securities.

Listing documents in the above cases are required to contain the specified information set out in Parts A and B of Appendix 1. Chapter 11 also covers the issue of a supplementary prospectus and profit forecasts.

18. **Companies Ordinance:** A listing document which is a prospectus under the Companies Ordinance (“CO”) must comply with the Listing Rules and must also comply with, and be registered in accordance with, the CO. The Listing Rules are completely independent of and without prejudice to the provisions of the CO. **Chapter 11A (Prospectuses)** refers to the vetting by SEHK’s Prospectus Vetting Unit of new listing prospectuses for compliance with the provisions of the CO. This vetting is done concurrently with the vetting for compliance with the Listing Rules. SEHK’s responsibility for CO prospectus vetting stems from the Securities and Futures Commission (Transfer of Functions) Order (“Transfer Order”), which transferred to the SEHK the SFC’s functions under S.38B (2A)(b), S.39D(3) and (5) and S.342C(3) and (5) of the CO for vetting prospectuses in relation to listed companies. Under the terms of the Transfer Order, SEHK vets any prospectus of shares and debentures approved for listing on the markets operated by HKEx and has authority to authorise registration of such prospectus by the Registrar General under the CO.
19. **Chapter 12 (Publication Requirements)** sets out the publication requirements for public announcements and includes provisions relating to publication of prospectuses on CD-Roms and/or the websites of listing applicants.
20. **Chapter 13 (Listing Agreement)** states that all listed companies must enter into a Listing Agreement with SEHK which sets out their continuing obligations

following listing. Appendix 7 contains prescribed forms of listing agreement for listings of equity securities by Hong Kong companies, overseas companies and PRC companies. The Listing Agreement contains provisions relating to board and shareholder meetings, the contents of annual reports and other financial disclosure, requirements for timely disclosure of price-sensitive information and numerous other matters.

21. **Disclosure of Price Sensitive Information:** Paragraph 2 of the Listing Agreement is a cornerstone provision requiring timely disclosure of price-sensitive information to ensure that the market and shareholders are kept fully informed on an ongoing basis. Paragraph 2 provides that a listed issuer must inform SEHK, its shareholders and the market as soon as practicable of any information which:
 - (a) is necessary to enable them and the investing public to assess the company's position;
 - (b) is necessary to avoid a false market in the listed company's securities; and
 - (c) might be expected to affect the price of its securities.

22. **Chapter 14 (Notifiable Transactions)** sets out the circumstances under which listed issuers are required to disclose details of corporate transactions, to send circulars to shareholders with information on such transactions, and in certain material transactions to seek prior shareholder approval. It should be noted that in cases where a transaction does not fall into the categories listed in Chapter 14 it may still be subject to disclosure under the issuer's general disclosure obligation in Paragraph 2 of the Listing Agreement.

23. **Four Tests:** Chapter 14 provides the following four tests to discern the category of transaction:
 - (a) Assets test
 - (b) Profit test

- (c) Consideration test
- (d) Equity capital test

Requirements for disclosure and shareholder approval are triggered by meeting certain thresholds for these tests (15%, 50% and 100%).

24. Chapter 14 divides corporate transactions into the following categories:

- (a) Very Substantial Acquisitions (“VSA”) – defined as any acquisition by a listed company of another business, assets or company, substantially all of which are unlisted, where one of the four tests would exceed 100% or which would result in a change of control (e.g. a reverse takeover). Such transactions (commonly referred to as “backdoor listings”) are conditional on shareholder approval and normally dealings in the listed company’s shares will be suspended pending an announcement. SEHK normally requires shareholders with a conflict of interest to abstain from voting. Where there is no intention to change the listed company’s business, the business to be injected is in a similar line of business and is not substantially larger than the listed company, no material change in control results and there is no significant change in the composition of the board of directors, the VSA may not be treated as a new listing;
- (b) Major Transactions – defined as any acquisition or disposal of assets (including securities) by the listed company where one of the four tests would result in a figure of 50% or more. Major transactions are subject to approval by shareholders in general meeting and consequently require the issue of shareholder circulars in addition to an announcement. SEHK normally requires interested shareholders to abstain from voting;
- (c) Discloseable Transactions – defined as any acquisition or disposal of assets (including securities) by a listed issuer where one of the four tests would result in a figure of 15% or more. Discloseable transactions require the issue of a shareholder circular, although approval of shareholders is not required, in addition to an announcement; and

- (d) Share Transactions – acquisitions of assets where the tests result in a figure of less than 15% but where the consideration includes securities for which listing is sought.
25. “Connected Transactions” are related-party transactions between a listed issuer and a substantial shareholder or director or a related person. SEHK normally requires that connected transactions be subject to an independent shareholders’ approval. There are certain “de minimis” exclusions from the disclosure requirements and shareholder approval obligations, which include small transactions on normal commercial terms. Independent shareholder approval is normally required among other things for the granting of options to acquire or dispose of assets to or from connected persons, the issue of new securities for cash to a connected person, financial assistance or the granting of an indemnity to a connected person other than on normal commercial terms, and the acquisition of an interest in a company in which a connected person is a substantial shareholder.
26. **Chapter 15 (Options, Warrants and Similar Rights)** sets out requirements for options, warrants and similar rights to subscribe or purchase equity securities of a listed issuer that are issued or granted by listed companies but does not apply to options granted under any employee or executive share option scheme (which are subject to the requirements of Chapter 17 – see below). All warrants must be approved by SEHK prior to their issue or grant and, in the case of warrants exercisable into equity securities, are subject to shareholders’ approval unless the securities are issued under the general mandate to issue securities.
27. **Chapter 15A (Structured Products)** sets out requirements for the issue of single stock and basket derivative warrants, including application procedures, qualifications for issuers and guarantors of collateralized and non-collateralised warrants, and requirements governing issue size, tenure and security and settlement arrangements. Other structured products, such as equity-linked instruments, are also dealt with in Chapter 15A.
28. **Chapter 16 (Convertible Equity Securities)** addresses additional prospectus disclosure requirements for convertible equity securities set out in Appendix 1.

29. **Chapter 17 (Share Schemes)** sets out SEHK's requirements governing share option schemes involving the grant by a listed company of options over new shares or other new securities in the listed group for specified participants. Such schemes must be approved by the listed company's shareholders in general meeting. Details to be disclosed include the duration of the scheme, the maximum number of securities to be issued upon exercise of the options under the scheme, the maximum entitlement of each participant in the scheme, any performance targets that must be achieved before an option can be exercised and how the exercise price is calculated. Chapter 17 also contains requirements governing the grant of options to directors, chief executives or substantial shareholders of a listed company and restricts the grant of options when price-sensitive events have occurred or until such event has been published in the newspapers.
30. Investment vehicles are covered in **Chapter 20 (Authorised Collective Investment Schemes)** and **Chapter 21 (Investment Companies)** respectively.
31. **Chapters 22 to 37** deal with securities and debt issuance programmes, including the requirements for supranational debt issues.
32. **Chapter 38 (Listing of HKEC)** which deals with HKEx's own listing sets out the SFC's and SEHK's respective powers and functions in relation to HKEx's listing and its ongoing status as a listed issuer. Chapter 38 highlights the agreed arrangements between the SEHK and the SFC for handling any conflicts of interest arising between HKEx and the listing applicants and listed issuers that it regulates.
33. **Practice Notes and Appendices:** Besides containing Chapters 1 – 38, Volume 1 also contains Practice Notes issued by SEHK to clarify certain requirements under the Listing Rules or to codify practice (for example, Practice Note 15 deals with proposals by listed issuers to list subsidiaries that form part of the existing listed group). Volume 2 contains Appendices which provide detailed disclosure requirements, listing agreements, codes of conduct and other matters.

34. **Appendix 1 (Prospectus Disclosure)** sets out the detailed disclosure requirements for prospectuses and listing documents for equity, debt and structured products.
35. **Appendix 7 (Listing Agreement)** sets out the listing agreement between issuers and SEHK which provides for listed issuers' continuing obligations.
36. **Appendices 3 – 6:** Appendix 3 - Requirements governing articles of association of listed issuers (which is supplemented in the case of certain overseas jurisdictions, including Bermuda, the Cayman Islands and the PRC, by the provisions in Appendix 13). Appendix 4 contains the requirements relating to the trust deeds of debt issuers. Appendix 5 contains the key forms relating to applications for listing, including the advance booking forms A1 and A2 for equity and debt issues; formal listing applications; the marketing form, which discloses the allocation of the securities distributed; directors' undertakings and the sponsor's declaration forms. Appendix 6 sets out SEHK's guidelines on placings, which also clarify its position on placings to connected persons and to discretionary funds. Appendix 11 sets out model forms of formal notice. Appendix 8 sets out SEHK's scale of listing fees and transaction levies.
37. **Appendix 9** sets out the Model Code for Sponsors of listed companies. SEHK and the SFC recently issued a Consultation Paper on the Regulation of Sponsors and Independent Financial Advisors with a view to improving the regulation of intermediaries.
38. **Appendix 10**, the Model Code for Securities Transactions by Directors of Listed Issuers, sets out internal control procedures and other requirements applicable to directors to prevent trading on inside information including inadvertent trading.
39. **Appendix 14 (Code of Best Practice)** contains SEHK's corporate governance standards for listed companies including such matters as the audit committee. This Code is due to be amended significantly in the context of significant changes to SEHK's corporate governance requirements, following the conclusion of its recent consultation exercise on corporate governance issues. The amended Code

is proposed (subject to Listing Committee approval) to have a two tier approach to corporate governance:

- (a) code provisions – for example the establishment of a remuneration committee, regular review by directors of the effectiveness of internal controls, and segregation of the role of chairman and CEO;
- (b) recommended good practices – for example, establishment of nomination committee for directors, report on effectiveness of internal controls, and quarterly reporting by Main Board issuers.

Listed issuers will be required to disclose any deviation from the code provisions in their annual report on corporate governance.

40. **Amendments to Listing Rules:** Additional changes to be reflected in new Listing Rules will include, among other things, shareholder voting by poll on connected and important transactions, refreshment of a general mandate being subject to independent shareholders approval and limits on the placing discount of shares under the directors’ general mandate (including a discount trigger threshold of 20%, below which SEHK would have to be satisfied that the relevant issuer was in a serious financial position or other exceptional circumstances which justified the deep discount in the share price on a placing), new requirements relating to independent non-executive directors, and further refinement of the classification of corporate transactions in Chapter 14 by the introduction of a “total asset value” test (which can be used rather than the net asset approach for the Asset Test and the Consideration Test), revised method of calculating the Consideration Test using market capitalisation as the numerator and a new transaction category (“very substantial disposal”, which will cover disposals of assets, businesses or companies and have a 75% threshold under the tests in Chapter 14).

SAFEGUARDS AGAINST CONFLICTS OF INTEREST

1. **Existing Safeguards** – One of Government’s main objectives in promoting demutualization of the exchanges three years ago was to eliminate conflict between the interests of the owners of the Exchange and those of investors and the general public. It was recognized by Government at the time that (despite the high degree of congruence between the public interest and the interest of public shareholders in HKEx), situations involving new types of conflict could arise. The same issue was faced by regulators in other markets where exchanges had demutualized. Various ways to deal with this issue were considered, including the transfer of the listing function to the SFC. After careful consideration, the SFC recommended, and Government endorsed, a decision to retain the so-called “three-tier” structure which we have today.

2. **Statutory Safeguards** – To address any possible conflicts of interest and to ensure that HKEx’s interests coincide with those of the public, a comprehensive set of safeguards was put in place by Government, Legco and the SFC. These included the following provisions in the Merger Ordinance:
 - (a) A statutory duty for HKEx to give precedence to the public interest over any other of its interests;
 - (b) An initial majority of public interest directors, followed in 2003 by parity between appointed and elected directors;
 - (c) Appointment of the HKEx Chairman by the Chief Executive of the SAR;
 - (d) Approval by SFC of the CEO and COO of HKEx;
 - (e) Approval by SFC of all fees and charges related to HKEx’s regulated activities, including listing fees;
 - (f) Power for SFC to give directions to HKEx if it considers a conflict of interest has arisen;

- (g) Provision that HKEx, as a listed company, would be regulated by SFC, not by SEHK.

Hong Kong safeguards follow closely suggestions from IOSCO for dealing with the issue of conflicts in the context of exchange demutualization.

3. **Memorandum of Understanding** – In addition to these statutory provisions, the 1991 Memorandum of Understanding (“MOU”) between the SFC and HKEx was updated and extended in a new MOU in 2000. This provided (among other things) for decision-making power on listing matters to be delegated by the Board of HKEx to the Listing Committee, whose members have no interest in HKEx’s revenue or profitability, and over whose appointment the SFC has a large measure of control. This delegation was also entrenched in the Listing Rules. In early 2003 (in anticipation of the “dual filing” regime) a further MOU was signed which clarified respective roles and responsibilities in listing rule policy development and acknowledged the SFC’s power to object to any particular listing if it wishes to do so.
4. **SFC Oversight of HKEx** – On top of these structural safeguards against potential conflicts, there is (of course) a statutory requirement that the Exchange’s Listing Rules (and any amendments to them) must be approved by the SFC. In addition, there is continuous close oversight by SFC of HKEx’s performance of its listing functions, including monthly reports and regular audits. At no time have these suggested that any of HKEx’s decisions were influenced by conflicts of interest.

SHARED REGULATION - THE NORTH AMERICAN AND SINGAPORE APPROACHES

1. **United States** – In the U.S., the Securities and Exchange Commission (“SEC”) administers statutory requirements that apply to listed companies and has oversight authority over the self-regulatory functions of the markets, including the NYSE and NASDAQ. The primary statutes governing securities regulation in the U.S. are the Securities Act (which governs prospectus disclosure and the public offering process) and the Exchange Act (which sets out disclosure requirements for listed companies and other “reporting companies”). These statutory disclosure requirements are the Form 10-K (annual report), the Form 10-Q (quarterly report) and the Form 8-K report on the occurrence of specified events. The key disclosure obligations are found in the Exchange Act while the detail of the information required to be disclosed is set out in subsidiary legislation (in particular Regulation S-K and S-X). These statutory requirements are broadly analogous to HKEx’s recommended changes to the SFO.
2. **NYSE** – The NYSE’s Listed Company Manual sets out the policies, practices and procedures which NYSE-listed companies are required to comply with. The Manual sets listing standards, disclosure requirements and corporate governance requirements. The NYSE’s requirements supplement both federal securities law and state company law. The NYSE corporate governance rules set out requirements for audit committees (including independence and expertise requirements) and shareholder approval requirements for related-party transactions and certain other major events that may substantially affect the rights of shareholders. The NYSE is subject to regulatory oversight by the SEC; changes in NYSE rules require SEC approval. The NYSE can be required to amend its listing rules (including its corporate governance requirements) and has in fact done so as a consequence of the Sarbanes-Oxley legislation. However, the NYSE remains responsible for administering the listing rules.
3. **Canada** – The system of securities regulation in Canada also involves shared responsibility between the statutory regulator and the exchanges. The statutory disclosure requirements in the Securities Act are broadly comparable to those in the

U.S. and those proposed by HKEx. The Company Manual of the Toronto Stock Exchange (“TSX”) sets out both initial and ongoing listing requirements. The listing rules in the Manual include timely disclosure requirements, financial reporting requirements and guidelines for corporate governance. The Commission is responsible for oversight of the TSX (which is a listed company) and approval of rule changes, while the TSX retains the responsibility to administer and enforce its listing requirements.

4. **Singapore** – The Monetary Authority of Singapore (“MAS”) administers the Securities and Futures Act (SFA”). The SFA sets out (among other things) the statutory requirements for prospectus offerings, takeovers and oversight of the Singapore Exchange (“SGX”). The SGX is a listed company. Like HKEx, the SGX administers its own listing rules and is the front-line regulator of listed companies. The responsibilities of SGX include reviewing listing applications, reviewing prospectuses, offering memoranda and shareholder circulars, and administering timely disclosure of information by listed companies. The Listing Manual of SGX sets initial and continuing obligations for listed companies. The SGX Best Practice Guide deals (among other things) with the principles and best practices of corporate governance.